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ABSTRACT

Reasons for continuing to allow the charitable deduction for income tax purposes rather than changing to a tax credit equal to 30 percent of a person's charitable donations are presented. It is projected that support for certain charities, primarily colleges and universities, would decline after implementation of a tax credit system. The current financial crisis in higher education and the role of voluntary support to institutions are discussed. Theoretical arguments against substituting a tax credit for charitable deduction are offered. The view of charitable deduction as a tax subsidy is contested, and the tax credit is viewed as less equitable than the deduction. It is proposed that a tax credit substitution would substantially reduce giving by high income individuals to make gifts. A tax credit for charitable contributions would increase the disposable income of the wealthy, decrease the income of middle- and lower-income individuals, and result in a less progressive distribution of income than with a charitable deduction. It is concluded that the proposal to substitute a tax credit for the charitable deduction is as a matter of tax theory questionable, is as a matter of tax policy less equitable than the deduction, and is as a practical matter unacceptable. (SW)

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A GUIDE TO TAX POLICY AND HIGHER EDUCATION

TAX STUDIES PAPER NO. 3

The Case for the Charitable Deduction: A Deduction, Not a Credit

U.S. DEPARTMENT OF HEALTH, EDUCATION & WELFARE
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THE CASE FOR THE CHARITABLE DEDUCTION:

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The Case for the Charitable Deduction: A Deduction, Not a Credit

A deduction for gifts to charitable organizations, including colleges and universities, has been an integral part of the income tax law since the Revenue Act of 1917. Congress has periodically reviewed and reaffirmed the wisdom and propriety of the charitable deduction. Throughout its sixty-year history, the deduction for charitable contributions has served well in stimulating private philanthropy and in enabling philanthropic institutions -- in the face of a continuously expanding government sector -- to continue to serve as a cornerstone of our pluralistic society.

Notwithstanding the manifold achievements of charitable organizations and the critical role of the charitable deduction in their funding, the propriety of the charitable deduction from time to time is called into question. Today, this challenge has taken the form of a proposal to replace the charitable contribution deduction with a tax credit equal to 30 percent of a person's charitable donations.[1]

The effect of a credit versus a deduction on an individual taxpayer can be illustrated by looking at the above example. Under a 30 percent credit, every taxpayer giving $100 saves $30 in taxes (assuming each taxpayer's tax bill is at least $30; if some owe less, then the credit will be only good for the actual amount of taxes owed). Under a deduction, a taxpayer giving $100 also saves $30 in taxes if he is in the 30 percent tax bracket. If his tax bracket is higher than 30 percent, he will save more than the $30 in taxes for making the $100 gift. If his tax bracket is lower than 30 percent, he will save less than $30 in taxes for making the $100 gift. The tax consequences of these calculations on giving to charity are discussed in this paper.

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[1]Senator Edward M. Kennedy has introduced in the last two Congresses tax reform legislation which included such a proposal, 123, Congressional Record, S. 11,408, S. 11,412 (daily ed. July 1, 1977). However, the Tax Reform Proposals, submitted in early 1978 to President Carter by the Treasury Department, outlined the case for a shift to the credit and then stated that Treasury is opposed to any change in the charitable deduction. See BNA "Daily Report for Executives," October 7, 1977, Special Supplement "Tax Reform Option Papers" at 25-26 (hereinafter cited as Treasury Tax Reform Option Papers).

The case for retention of the charitable contribution deduction is compelling. Even the most outspoken opponents of the charitable deduction recognize that colleges and universities are among the most financially strained of nonprofit organizations and agree that any substitute for the deduction should assure educational institutions support equal to "that which they can reasonably anticipate from the present tax expenditure system."[2]

But those who advocate direct government grants as a substitute for the charitable deduction concede that support for certain charities, primarily colleges and universities, would necessarily decline. Likewise, the suggestion enjoying the most attention today -- that the charitable deduction be replaced by a tax credit -- suffers this same critical defect. Such a change would decrease charitable contributions to colleges and universities and would, at the same time, fail to achieve its stated objective: an improvement in equity.

The Importance of Voluntary Support to Colleges and Universities

The current financial crisis in higher education has been well documented elsewhere[3] and will not be detailed here. The prognosis for the future continues to be bleak. Those factors which have produced the current era of financial distress do not seem likely to abate. Relief from the cost-price squeeze produced by inflation and rising costs is not in sight. Recovery from the disastrous erosion of capital asset values of recent years likewise seems a long way off. Government spending restraints also seem likely to continue. The general economic climate remains uncertain. In addition to this alarming economic backdrop, colleges and universities are now facing a leveling off of enrollment, with an absolute decline in enrollment expected by the middle of the 1980's. In this context, educational institutions cannot expect to offset rising costs through increases

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[2] McDaniel, "Alternatives to Utilization of the Federal Income Tax System to Meet Social Problems," 11 Boston College Industrial and Commercial Law Review 867, 880 (1970).

[3] See, e.g., Lanier and Anderson, A Study of the Financial Condition of Colleges and Universities: 1972-1975 (American Council on Education, 1975); Filer Commission Report, supra note 4, and the five volume Research Papers sponsored by this commission and published by the Treasury Department in 1977 (hereinafter cited as Research Papers); Association of American Universities, Tax Reform and the Crisis of Financing Higher Education (1973).

in government grants, student fees or endowment income.[4] The continued vitality of this nation's colleges and universities is critically dependent upon the financial support provided by voluntary donations from individuals, foundations, and corporations.

In 1977-78 colleges and universities received an estimated $3.04 billion of voluntary support. This accounted for about 6.1 percent of total expenditures.[5] Based on an average five percent yield, this sum represents the equivalent of income from an additional endowment of $61 billion, which is more than three times the total $16 billion endowment reported by institutions of higher learning in 1977-78.[6] Gifts from higher income individuals are especially important to educational institutions. More than 75 percent of total voluntary support for higher education comes from the less than five percent of donors who contribute $5,000 or more.[7] Revisions in the income tax laws hostile to large contributions by such individuals would be harmful to higher education. Both public and independent colleges and universities desperately need all the resources now available to them and dramatically more. They simply cannot afford any diminution of private charitable gifts.

Effect on Giving: Deduction Versus Credit

The substitution of a 30 percent tax credit for the charitable deduction would cause charitable gifts to educational institutions to decline "significantly."[8] Although the credit would reduce the after-tax costs of charitable giving for individuals with marginal rates less than 30 percent, it would impose higher taxes on those with marginal rates in excess of 30 percent. A 30 percent credit would double the after-tax costs of charitable donations by taxpayers in the highest brackets. The net effect of substituting a 30 percent credit for

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[4] Treasury Tax Reform Option Papers at 25.

[5] Council for Financial Aid to Education, Voluntary Support of Education 1977-78, at 3, 7 (hereinafter cited as CFAE Study).

[6] CFAE Study at 69.

[7] J. Levi and S. Steinbach, Patterns of Giving to Higher Education II: An Analysis of Voluntary Support of American Colleges and Universities, 1970-1971 (Washington, D.C.: American Council on Education).

[8] Treasury Tax Reform Option Papers at 25.

charitable deduction would be to decrease giving to private schools, colleges, universities, museums, and hospitals and to increase after-tax, after-gift income of higher bracket taxpayers. These institutions would bear the burden nominally imposed on higher income contributors.[9]

A 30 percent tax credit would produce a 17 percent reduction in charitable giving to educational institutions. This estimate is based on a study by Professor Martin Feldstein of Harvard, based on the 1970 Treasury Tax File.[10] The staff of the Council of Economic Advisers has made a much smaller estimate of the impact of this change on educational institutions, predicting that giving would decline by only three percent.[11] However, as a memorandum from the Treasury Department to President Carter indicates, this estimate is crucial to the CEA posture on this issue and is "contrary to most empirical work."[12] At 1975-76 levels of giving, the Feldstein model documents a reduction in annual giving to colleges and universities of more than $400 million -- an amount which would require an additional endowment of $8 billion to offset -- a loss colleges and universities simply cannot afford.

Not only have proponents of the tax credit approach seriously underestimated the adverse impact of such a proposal on colleges and universities, but also may have overestimated the increase in giving to other charities. If a credit approach were adopted, the Treasury Department has demanded that the credit be allowed only for those gifts in excess of a "qualifying" floor. Otherwise, the Internal Revenue Service would be allegedly faced with a vastly increased task of auditing charitable contributions of very small amounts.[13] Estimates of

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[9] Treasury Department, Blueprints for Basic Tax Reform (January 17, 1977) at 97.

[10] Feldstein and Taylor, "The Income Tax and Charitable Contributions: Estimates and Simulations with the Treasury Tax Files," in 3 Research Papers at 1419, 1435. The Treasury Tax Reform Option Papers at 25, state that: "Recent empirical work supports the view that a 30 percent increase in the cost of giving will reduce gifts by about 17 percent assuming present law rates" (emphasis added). Since a 30 percent credit would involve more than a 30 percent increase in the cost of giving for higher bracket taxpayers, this would imply a greater decline in donations to higher education than that suggested in the text. It is likely, however, that the Treasury statement was intended to support the conclusions of Professor Feldstein and merely misstated his results.

[11] Treasury Tax Reform Option Papers 1 at 25.

[12] Id.

[13] Treasury Tax Reform Option Papers at 25; Statement of Senator Kennedy, supra note 1, at S. 11,412.

increased giving by lower income individuals should be reduced to account for the impact of a floor in disallowing any tax advantage for small gifts.

Religious organizations, which are among the charitable organizations most favored by lower income taxpayers, and therefore among those most likely to benefit from a shift to a tax credit, are strongly opposed to the change. Their opposition rests chiefly on the doubtful constitutional validity of the credit under the first Amendment principle of the separation of church and state. Moreover, they apparently perceive lesser benefit than those claimed by proponents of a credit.[14]

Theoretical Arguments Against Substituting a Tax Credit for the Charitable Deduction

The principal argument advanced by proponents of a tax credit is that a credit would be more equitable than the charitable deduction. This argument characterizes the charitable deduction as a subsidy to charitable giving, compares the deduction to a program under which the government makes matching grants to charities chosen by taxpayers, and suggests that since it conditions the amount of the government's grant directly on the taxpayer's marginal income tax rate, the charitable deduction is an inequitable, "upside-down" matching grant program. A 60 percent bracket taxpayer can contribute $100 with an after-tax cost of $40, but a 30 percent bracket taxpayer will have an after-tax cost of $70 for making the same contribution.[15]

While this view of the charitable deduction as a tax subsidy has been accepted for purposes of the Treasury's "Tax Expenditure Budget," it is by no means free from substantial historical, theoretical and policy criticisms.[16]

First, the purpose of taxation is to shift resources from private use to public use. Private use consists of private consumption plus private savings. These two quantities equal net income which is the basis for taxation under our system. But charitable giving, arguably, is neither a form of personal consumption nor personal savings because the benefits produced are available to the public and are not available

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[14] Treasury Tax Reform Option Papers at 25.

[15] See, e.g., Statement of Senator Kennedy, supra note 1, at S. 11,412.

[16] See, e.g., Andrews, "Personal Deductions in an Ideal Income Tax," 86 Harvard Law Review 309 (1972), reprinted at 4 Research Papers at 2163; Bittker, "Charitable Contributions: Tax Deductions or Matching Grants?," 28 Tax Law Review 37 (1972).

only or necessarily at all to the donor. Therefore, to properly measure net income for tax purposes of the donor, the law must in theory allow a tax deduction for charitable giving. A tax credit would be in theory incorrect. It would result in an excessive theoretical adjustment against income for some taxpayers and an insufficient theoretical adjustment for others.[17]

Second, the tax credit would be less equitable than the deduction. The substitution of a tax credit for the charitable deduction is usually asserted as a means to make the income tax more progressive, and to eliminate so-called "upside-down" benefits for the wealthy. Tax credit proponents, however, ignore the practical consequences of the change they are advocating. Substituting a tax credit for the charitable deduction would have progressive impact only if charitable giving remained unchanged.

The overwhelming empirical evidence demonstrates, that a tax credit substitution would substantially reduce giving by high income individuals to make gifts.

With a tax credit, lower income taxpayers would give more to charities and would have less income to spend for consumption, while

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[17] A charitable deduction insures that no one pays tax on amounts contributed to charity regardless of tax bracket. A tax credit, on the other hand, will penalize the highly productive and generous man who shares his or her income with charity by taxing him on contributed amounts. For low bracket taxpayers, however, a tax credit will not only exempt from tax amounts contributed to charity, but will also have the effect of reducing tax on income which is used for personal consumption. In the works of Professor Andrews:

> "(T)he net effect of substituting a credit for the deduction would be to tax some contributors on their contributions while subsidizing others, and so viewed the suggestion seems to be a very doubtful one. That is, it is understandable to say to a high bracket taxpayer that he will not be taxed on funds devoted to philanthropic uses of his own choosing. And it is understandable to say, if necessary, that a high bracket taxpayer will be taxed even on such funds because there are other more pressing needs as determined and identified by government action. But it is much less understandable to tell a high bracket taxpayer that he will be taxed on funds devoted to his favorite philanthropies in order to provide funds for the support of other people's philanthropies beyond what they would have been able to provide if no tax had been imposed at all." Andrews, 86 Harvard Law Review at 366; 4 Research Papers, supra note 6, at 2195.

upper income taxpayers would give less to charities and thereby be in a position to increase their own consumption. The decline in charitable giving by higher income taxpayers would be greater than the increased taxes they would be required to pay, and the after-tax distribution of disposable income would be less progressive with tax credit than with the charitable deduction. Professor Feldstein has estimated that households with income in excess of $100,000 would actually have between five and eight percent more income available for personal consumption if a tax credit replaces the charitable deduction.[18]

The regressive effect of substitution of a tax credit for the charitable deduction would be further exacerbated to the extent that federal or state governments find it necessary to increase support to colleges and universities to offset the decrease in funding from high income individuals. When an independent university such as the University of Buffalo or Pittsburgh is forced, because of inadequate voluntary support to close, or become a state institution, the effect may be to substitute a regressive source of funds, such as the sales tax, for a progressive source of private funds.[19]

As a practical matter, it is a tax credit for charitable contributions which has the "upside-down effect," increasing the disposable income of the wealthy, decreasing the income of middle and lower income individuals, and resulting in a less progressive distribution of income than with a charitable deduction. The tax deduction for charitable giving does not profit the individual taxpayer; rather it benefits the educational, religious and scientific institutions so critical to our nation's well-being. When an individual contributes to a college or university, he achieves no monetary gain for himself. The effect of charitable contributions is the redistribution of wealth, not the conservation of personal wealth. Rather than viewing the charitable contribution deduction as a loophole for the wealthy, we should view the amounts donated as an additional tax -- albeit a voluntary one -- paid by individuals to provide goods and services for the benefit of the public. As the Treasury stated in its Blueprints for Basic Tax Reform, "If gifts are regarded as reductions in the donors income and if rates of tax are chosen to produce a desirable degree of tax progressivity, then the deduction is to be preferred on equity grounds."

Thus, the proposal to substitute a tax credit for the charitable deduction is as a matter of tax theory questionable, is as a matter of tax policy less equitable than the deduction, and is as a practical matter unacceptable.

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[18] Feldstein and Clotfelter, "Tax Incentives and Charitable Contributions in the United States: A Microeconomic Analysis," in 3 Research Papers, at 1393, 1412.

[19] See Association of American Universities, Tax Reform and the Crisis of Financing Higher Education at 25-26 (1973).